New England's Economy: The Current Outlook and Challenges Ahead

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January 8, 1999

Good afternoon. It's a pleasure to speak here at the 8th annual Vermont Economic Outlook Conference. I'd like to congratulate Art Woolf on the continuing success of this important kick-off to the New Year.

My comments today will focus on facts, fallacies and the future. First, the facts of the solid economic picture we see as 1999 begins. Second, I want to address three of what I view as fallacies that seem to shape how some view the domestic scene: (1) inflation is dead; (2) asset markets only go up, or, its corollary, "I don't need to save because the stock market will provide for my retirement," and (3) business cycles are a thing of the past. Finally, I'd like to focus on the likely prospects for 1999, and spend some time on that now all-important topic, century date change readiness.

As I think about the state of the national economy at the end of 1998, I am reminded of the situation at the beginning of 1995 when I last spoke at this Conference. Back then I noted with some satisfaction that the U.S. unemployment rate had fallen to 5.4 percent at the end of 1994, yet inflation remained well contained, with the CPI up only 2-1/2 percent from a year earlier. Today, the unemployment rate is even lower-4.4 percent in November-and the CPI is up just 1-1/2 percent from a year ago. This combination of low unemployment and inflation hasn't been seen since the early '60s.

Similarly, both 1994 and 1998 had surprising overall strength. GDP growth for both years remained unusually strong, instead of slowing as most forecasters predicted. For third quarter 1998, real GDP growth clocked in at an annual rate of 3.7 percent, and it now looks as if growth for fourth quarter '97 to fourth quarter '98 will be roughly the same. This is a good deal faster than most forecasters had expected. Indeed, FOMC member forecasts for 1998 as they were summarized for Congress last February had growth clustered between 2 and 2-3/4 percent. The Administration's forecast was even lower--only 2 percent--and most private forecasters fared no better. The underlying resilience of the U.S. economy continued to surprise, even as it surprised forecasters in 1994. Indeed, over the last four years, GDP growth has averaged 3.4 percent, well over most estimates of the economy's potential. At the same time, 11 million net new jobs were created, unemployment dropped to its current low, and the rate of inflation moved steadily downward.

There are two critical bulwarks to the economy's current success: the consumer, and the drive of U.S. businesses to become more competitive. On the consumer side, spending on motor vehicles, houses, and other durable goods and services has surged beyond expectations. People are employed at an historically high level, interest rates are low, and confidence about the current situation, and the future, while bouncy, remained at high levels in 1998.

Some of this consumption growth is likely also driven by the behavior of asset prices. Arguably, people feel wealthier when their assets are worth more, and the wealthier people feel, the more they are willing to spend and the less they believe they need to save out of current income. Thus, we see the personal savings rate falling from the early '90s recession years to nearly zero currently - this isn't a good thing, as I will point out later, but it has happened.

Businesses have reacted to strong domestic consumption by continuing to hire workers. Compensation costs have increased, but competitive pressures have increased as well. As a result, businesses have responded by investing in technology to reduce costs and improve product offerings; have restructured business processes, merged, or divested less than stellar operations, and have turned to ever more creative compensation practices, linking pay directly to performance. Thus, compensation cost increases have been cushioned, at least for the present.

This is not to say that everything is rosy. You have already heard about the risks to the U.S. economy from international developments. I won't go into these at length except to say that so far their impact has been largely felt in three areas: declining net exports with their marked effects on the manufacturing sector, plummeting commodity prices and increased volatility and risk in financial markets. The U.S. trade deficit hit an all time high in August, reflecting the combination of economic problems internationally which dampened foreign demand and buying power, the relatively much healthier U.S. economy, which prompted growth in imports, and the low domestic savings rate I noted earlier. The drag on growth from worsening trade was greater early in the year, when GDP growth slowed to a 1.8 percent pace in second quarter. However, given the strength of first quarter, and the surprising resilience of the third and fourth quarters, reduced demand emanating from the external sector, while reflecting enormous problems for the countries involved, was not altogether a bad thing for the U.S.

Similarly, slack conditions abroad contributed to driving commodity prices to extraordinary lows. To name just a few, crude petroleum prices at year-end 1998 were down 40 percent from the previous year; scrap metal prices were down 20-40 percent, and certain agricultural products--hog prices, for example-- were down 60 percent. Commodity price declines helped keep the rate of inflationary growth low, but they also caused problems for commodity producers here in the U.S.-- in the agricultural sector for example. Moreover, weak commodity prices have had adverse implications for countries as diverse as Mexico, Canada and Russia.

In Canada, the effect has played out in part through the fall of the Canadian dollar in foreign exchange markets, a matter of some concern to that nation. In Mexico, declining oil prices have reduced government revenues forcing very substantial and painful budget cuts. In Russia, declining oil prices made the government's precarious fiscal position even more so, and contributed materially to that country's highly destabilizing decision to devalue its currency and delay payments on its debt.

The cumulative effect of the Russian problem and the Asian crisis which preceded it finally reached the United States early this fall. The debt and equity markets fell sharply as U.S. investors became more risk-adverse and shifted funds to the U.S. Treasury market. This flight to quality also caused the spreads between U.S. Treasury bills and corporate securities to widen dramatically. Yields soared on junk bonds and the debt of emerging market and developing countries. For a brief period, it was almost impossible for private sector borrowers to raise funds in the capital markets. Fortunately, banks played the role of shock absorbers and increased their lending, and easing of monetary policy here and elsewhere provided some cushion. Since then, conditions in the financial markets have improved, but vulnerabilities on the external side remain.

Thus, the facts tell us the domestic economy is strong right now, though not without significant challenges. The major question is how long can it stay that way? Some of the answer to that involves how we react to the three fallacies I noted earlier.

First fallacy - inflation is dead. As tempting as this is to believe, I don't think it is likely. Moreover, to act as if it might be is dangerous as events have proven in the past. In my view, the traditional logic that tight labor markets produce higher labor costs, which further induce rising prices still makes sense. After all, labor input remains about 60 percent of final goods prices. But labor markets have been tight for some time now, and the rate of overall price growth has declined, not risen.

I would argue there are a number of reasons why the U.S. has had such a long period of declining inflation rates even in the face of strong growth. First, some credit has to go to the credibility achieved by the Federal Reserve in its battle against inflation since the early '80s. Expectations of inflation are low, as far as we can measure them, and this feeds back in many ways to price-setting in the economy. Second, for at least the early part of the period since the last recession, growth was slower than normal. Arguably this slow growth and corporate restructuring helped hold down labor costs when unemployment rates began to fall. In addition, benefit cost growth, especially medical benefits, slowed dramatically in response to increased competition and restructuring. This also kept overall compensation growth from accelerating even as labor markets tightened. Third, now that compensation cost growth has picked up more or less in line with traditional models of unemployment levels and wages, a couple of at least partly temporary factors continue to keep broad price growth low.

Earlier I noted business spending to improve productivity and competitiveness is one mainstay of our current economic picture. Such productivity growth has allowed firms to increase compensation without incurring higher unit labor costs. But questions abound. Is such productivity growth in part cyclical as well, reflecting the economy' s current strength? If so, it could be temporary. Or is this productivity growth secular, reflecting the investments I noted in information technology and more efficient labor market practices? If it is, then productivity growth may be lasting. I don't know the answers to these questions, but recent data suggest productivity increases are starting to be overtaken by continued compensation gains.

Commodity prices are also holding the rate of inflation down. The crisis in Asia and its spillover have reduced demand for commodities, and prices have tumbled as I mentioned earlier. However, commodity prices cannot fall at this pace forever. What happens when they stabilize, and world markets recover?

If labor markets remain as tight as they are now, an increase in inflationary pressure seems inevitable at some point. I do not believe inflation is dead at current levels of labor market tightness. It is quiescent because of the combination of cyclical timing and what may be partly temporary factors. It is true that most U.S. businesses, especially those that produce tradeable goods, firmly believe they have no pricing power. But this could change as international markets firm. Clearly, central bank vigilance is important here.

This takes me to the second fallacy. "Asset markets always go up," and its corollary "I don't have to save because the stock market will provide for my retirement." I don't have to tell a group of New Englanders about the dangers of inflated asset prices; the '90s recession lingers in our memory as proof of the dangers of asset inflation. Arguably, rising asset prices and the related feedback to consumer confidence convince consumers to maintain higher spending rates than they would otherwise. When such prices level off or come down, a reverse "wealth" effect could become evident. For businesses, a soaring stock market makes the cost of equity capital low; if this changes, investment spending could change as well.

After several years of rising corporate profits, 1998 saw a leveling off or an actual decline in profits, depending on the index used. Some indicators of valuations in equity markets, price earnings ratios, for example, seem high by historical standards. Plausible arguments have been made as to why such indicators are justified, though overall market volatility has increased. Asset markets can't always go up, and this indeed could have consequences for the real economy.

Finally, there is the fallacy that the business cycle is dead. Don't bet on it. This recovery started slowly, but has gained sizeable momentum. But there comes a time when consumers neither desire nor can afford another house or car, and businesses have invested as much as they reasonably can employ. Things slow down and, if all has been handled well, growth can continue at a slower and more sustainable pace. This is not the traditional pattern, however. In recent decades the growth phase of most business cycles has come to an end typically because growth got out of hand, inflation surged, and policy had to be tightened. To be sure, we've had a stronger economy with less inflation than most observers, myself included, expected. Still the capacity of the economy is not unlimited. Thus, in my view, some of the answer to whether or not this expansion continues, albeit at a slower pace, relies on how the threat of overshooting is handled. Again, a case for central bank vigilance.

Looking forward to 1999, I have some confidence that fiscal discipline and central bank vigilance will pay off. The domestic economy remains vital, and there will be considerable momentum from fourth quarter growth. However, there are reasons to believe growth will settle in to a more sustainable pace. The drag from the external sector remains, though it is not expected to be as large for the year as a whole as it was in 1998. Financial markets remain volatile and are a continuing area of concern. Just a leveling out of stock prices would give consumers reasons to resume more traditional patterns of saving and rein in consumption spending. Finally, businesses seem likely to restrain their spending in the face of weaker profit growth and a slower economy. As the economy moves into a more sustainable and, in my view, desirable pace, the Federal Reserve's three rate reductions provide a bit of insurance against downside risk.

To be a bit more specific, I expect overall GDP to run somewhere between 2 - 2-1/2 percent in 1999, and for unemployment to stay at a relatively low level. Not as upbeat as 1998 to be sure, but far from problematic. Given labor market tightness down the road, inflation risks remain. I expect there will be a modest tick-up here, if only because it is hard to imagine oil prices declining the way they have this year. Now, I should point out that if it is realized, this

forecast is almost the definition of the proverbial soft landing. Or, in other words, it doesn't get much better than this, particularly after the uncertainties of the last half of 1998.

But there are risks. The international situation - Brazil, for example - could present significant issues. Moreover, the strength of the domestic situation holds the potential for surprise as well, especially considering the fact that while a slowdown is expected, there is little yet in the incoming data to suggest it has started in earnest. Thus, there are challenges for monetary policy - striving to maintain a balance between upside and downside risks, even in the face of what is a very good current picture, and a reasonably benign forecast.

Now let me turn to one risk for 1999 that I haven't yet discussed. That is the challenge presented by the new millenium and its potential impact on computer systems worldwide. This could be a speech all by itself, but let me briefly cover a couple of thoughts. First, in my view, much progress is being made toward bringing systems in the financial services arena broadly speaking into compliance. Just speaking for ourselves in the Federal Reserve, we have implemented needed Y2K changes to nearly all of our mission critical systems, and have been testing with depository institutions since mid-year. More than half the 12,000 depository institutions that have on-line connections with Reserve Banks have tested, including all large providers of banking services.

All depository institutions have been examined for Y2K readiness once, and most twice by now. The exams are getting tougher, but we are reasonably confident the banks will pass muster, or quickly address issues if they arise. The securities industry is at least on a par with banking, as are major exchanges and clearing houses. We have also tested with social security and the U.S. Treasury, and their systems to pay benefits to people are compliant. The Federal Reserve chairs an international group focused on Y2K progress in the financial arena, and much is being done there as well. It is tempting to think that the reasonably successful conversion to the Euro this week bodes well for European readiness but Y2K in many respects is a tougher system problem. Finally, the President's Council on Year 2000 has been very effective in my view in getting a wide variety of industries and utilities focused on this matter.

Second, while some would suggest that Y2K problems could effect the economy quite a bit in 1999 or 2000, I view the likelihood of this as not great, though there could be some fluctuations induced, for example, by inventory building and rundown. Beyond that, the Federal Reserve is actively engaged in addressing potential problems and will do all it can to ensure an orderly transition. In that regard, the Reserve Banks plan to have as much cash as is necessary available through a process of continuous assessment of public need and related adjustment in printing plans.

Finally, I would caution all of you to be calm in the face of overheated millenium rhetoric. Will there be glitches? Sure there will. But I believe problems will be short lived, or emanate from areas where longer outages present few day-to-day concerns.

Moreover, the best defense against the probability of problems is the offense of thorough testing of new systems and planning for reasonable contingencies. Here we in the Federal Reserve are hard at work, as are others nationally and internationally. I would encourage you all in your own businesses to do the same.

Thank you.

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